COMMENT ON "PUBLIC VERSUS REGULATED PRIVATE ENTERPRISE," BY WILLIG

Jean-Jacques Laffont

Drawing on his original work with Carl Shapiro, Robert Willig has given us one of the rare substantive discussions addressing the comparison between public firms and regulated private firms. This question is particularly apt in the case of a severe natural monopoly (by which I mean a monopoly whose fixed costs are so high that the option of duplicating them to benefit from yardstick competition is not available).

The comparison is not an easy one because any imperfection in government management of a public firm reappears as an imperfection in government regulation of a private firm. Sappington and Stiglitz (1987), as well as Shapiro and Willig (1990), explain that in a complete contracting framework the two institutions are equivalent. To quote Shapiro and Willig, "The form of ownership matters only if there is some private noncontractible information." Any theoretical difference thus depends on incomplete contracting.

Let me first say that I would have appreciated an empirical evaluation of the gains from privatization for regulated firms, especially at a meeting hosted by an institution that has widely supported it. Willig offers no personal statement favoring one form or another, and rightly so. First, such empirical facts should be carefully separated according to the quality of the democratic institutions concerned. In the case of old democratic countries such as England or France, there is no clear empirical evidence on the superiority of either form of ownership, especially when we are interested in the quality of such long-run decisions as investments. The empirical evidence is either nonexistent or mixed; some public firms do badly, others do well.

I would like to challenge two of the paper's assumptions. The first is that the government is better informed about an enterprise's costs if it is a public enterprise than if it is a private firm. This is a crucial and debatable assumption,

Jean-Jacques Laffont is professor of economics at the Institut d'Economie Industrielle in Toulouse, France.

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despite its commonsense flavor, for two reasons. First, the analysis suppresses the role of the manager of the public firm—the person who has direct access to the firm's information and whose objectives are different from those of the official in charge (particularly if the official has a private agenda, as assumed here). The manager's objectives may be purely private, but then again they may be purely public, as civil servants all over the world like to claim.

The second reason is that the political structure becomes highly relevant for this question. In France during the 1980s, for example, the Finance Ministry, which served as the regulator of newly nationalized firms, claimed that it was less informed about the firms when they were in the state sector than when they were privately owned. Formerly these firms were required to provide information to the government to justify continuing subsidies; now, however, the directors of the newly private firms could bypass the ministry because of their political connections and could go straight to the president.

Once the nature of the principal-agent problem in the public firm is recognized, we can see that the government's information will be different in the two contexts. In the public enterprise the government may have better direct access to information. If the private regulated firm, however, is quoted on the stock market, the information reflected in the market price will be available. (See Laffont and Tirole 1991 for a discussion of dual control by regulators and stockholders.) I would say, therefore, that we need more empirical evidence of the hypothesis that the government is better informed when firms are public than when they are private.

The second assumption in the Willig paper is that the official in charge of the public enterprise has a private agenda (a nondebatable hypothesis) and that it is impossible for the framer—or the constitution—to systematically counteract such an agenda. Consider the case the paper describes as discretionary regulation. Good democratic institutions place strong limits on the government official's ability to pursue his or her own agenda. Clearly, the extent to which the official criteria deviate from social welfare will depend on the particular country's political and administrative institutional structure. For this reason, I consider this question of privatization more a matter of political science than of economics.

Willig explains that because of the informational rents that obtain in the case of the private firm, its activities (and therefore social welfare objectives) are less sensitive to the official's private agenda than are those of a public firm. If therefore, a minister has a large private agenda, a private firm may be preferable to a public firm.

I am not sure that I understand why the same results can be expected in the case of nondiscretionary governance. I believe that Willig fails to see the power of the revelation principle of incentive theory. If the framer was able to contract without limit with the government agency and with the chief executive of the firm—despite asymmetric information—the optimal contract would favor public ownership because in Willig's model private ownership puts more constraints on the regulator. Thus the presence of noncontractible information affects private and public enterprises differently, as Shapiro and Willig rightly note. But, in addition, the difference is nontrivial only if the complexity of the contracts (or nondiscretionary regulations) is limited. In the by now familiar language of economists, the privatization discussion should be in the context of a world of incomplete contracting. This is indeed realistic but is delicate from a theoretical point of view because the assumptions about the nature of incomplete contracts may seem quite ad hoc.

So far we have seen that incomplete contracting and asymmetric information in the case of private firms can be better than incomplete contracting without asymmetric information in the case of a public firm. As the paper notes, incomplete information may prevent a nonbenevolent official from pursuing a private agenda.

Note that all the analysis has been carried out so far in a static model in which commitment problems are apparently ignored. This is surprising, given Willig's statement that an essential factor in the success of privatization is "the government's ability to . . . commit itself to laissez-faire or to a limited and predefined regulatory mechanism." He argues that the framer must be able to commit to regulatory institutions that protect private firms from expropriation. But note again that once agency relationships are introduced in the public sector, similar issues of expropriation appear. It may even be argued that managers of public firms may fear expropriation of their specific investments in public firms more than managers of private firms because there is a greater congruence of managers' and stockholders' interests in private firms.

It is thus necessary to pursue the analysis in a dynamic context with the same emphasis on asymmetric information and incomplete contracting shown in Shapiro and Willig (1990). Technical difficulties, such as the ratchet effect generated by dynamic strategic behavior under incomplete information, will affect the outcome. But limited commitment may then produce results similar to those described in the case of a nonbenevolent official. Indeed Riordan (1987) and Sappington (1987) have developed models in which the regulator wants to commit to procedures that rely on imperfect monitoring. The idea is that where no commitment has been made, imperfect knowledge about the firm's technology constitutes a credible promise not to extract the firm's rent (see the model of privatization in Schmidt 1990.)

As for relevance, we must ascertain the cost to public firms of the lack of capital market monitoring and the absence of financial takeovers, the meaning of the so-called soft budget constraints of public firms, the various risks of expropriation of managers' and stockholders' investments, and the differences in lobbying and corruption in the two institutions. Furthermore, we will have to recognize that a whole continuum of institutional forms is available beyond the extreme cases considered here. Then we will start to have an understanding of the various tradeoffs involved. Meanwhile, it is important to dissociate the legitimate demands for democratic reform from the much more tricky and debatable choice between public or private ownership of natural monopolies.

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